*64-SBE-050

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GEORGE E. NEWTON)

Appearances:

For Appellant: James G. Fay,
Certified Public Accountant

For Respondent: Burl D. Lack,
Chief Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of George E. Newton against proposed assessments of additional personal income tax in the amounts of $2~88.21, $1,393.49 and $105.73 for the years 1955, 1956 and 1957, respectively.

The questions raised by this appeal are: (i) whether appellant George E. Newton's unreimbursed advances to a corporation in which he was a majorit stockholder are deductible by appellant as a bad debt, and (23 whether appellant is entitled to a deduction for attorneys' fees paid by him in connection with a divorce action.

Appellant was the sole proprietor of Aircrait X-Ray Laboratory, a business which was engaged In testing airplane and missile parts. In 1951, appellant decided to form a corporation to manufacture castings for airplane companies.

Airframe Manufacturing Company (hereafter referred to as "the corporation") was incorporated under the laws of California on October 26, 1951. The initial paid-in capital totalled $10,000, and appellant acquired 81 percent of the common stock Issued. The remaining 19 percent of the stock was held by employees of appellant.

The corporation commenced business on November 1, 1951. In order to begin-operations additional working capital was necessary, and appellant advanced substantial sums of money to the corporation during its early existence, The corporation suffered continued losses and appellant made smaller advances as they became necessary. Corporate operations ceased on August 31, 1955, and the company was subsequently liquidated, A schedule of the corporation's losses and appellant's advances follows:

Income year ended	Net Loss	Net Balance of Advances
October 31, 1952	($13,807.02)	$53,375.45
October 31, 1953	(1,932.46)	59,923.86
August 31, 1954	(1,621.44)	27,332.52
August 31, 1955	(18,465.00)	34,565.89

No instruments of indebtedness were created at any time, though the advances were carried on appellant's books as an account receivable and on the corporation's books as an account payable.

The liquidation of the corporation's assets in late 1955 failed to produce funds sufficient to pay all outside creditors of the corporation, Because he dealt with many of those same creditors in connection with his sole proprietorship, and because the two businesses were closely allied, appellant deemed it advisable to avoid bankruptcy proceedings on behalf of the corporation by paying amsunts owing to the creditors from his own funds, Accordfrgly, after cessation of the corporation's business, he paid $12,682.16, $7,919.62 and $3,039.79 to creditors of the corporation and deducted these amounts from his returns for the years 1955, 1956 and 1957, respectively. Respondent allowed the deductions for 1956 and 1957, on the ground that bankruptcy proceedings involving the corporation would have adversely affected appellant's sole proprietorship.

in his 1955 return, appellant deducted $47,248.05 as "Non Recoupable Advances - Airframe." This amount included the $12,682.16 paid to creditors of the corporation after its business ceased, Because no such specification was made until this appeal was filed, respondent disallowed the entire amount, concluding that the advances constituted capital investments and not loans to the corporation and were therefore not deductible as bad debts, Respondent does not. dispute appellant's contention in this appeal that the sum of $12,682.16, being in the same class as the sums paid to creditors in 1956

and 1957, was deductible. (See Allen v. Commissioner, 283 F.2d 785.) Respondent maintains its position, however, that the advances made while the corporation was operating were capital investments.

During the taxable years involved in this appeal appellant's former wife, Wilma Estella Newton, sued him for divorce. Mrs. Newton contended that appellant's business constituted community property and that she was therefore entitled to a portion of it upon severance of the marriage. In defense of the action appellant incurred certain legal fees of his own, and he was also obligated under the interlocutory decree of divorce to pay $10,000 to his wife's attorneys. In filing his tax returns appellant deducted all fees paid to his attorney during 1955, 1956 and 1957 for services rendered in connection with the divorce action and $5,000 paid to his wife's attorneys in 1956. Respondent disallowed deduction of 25 percent of the amounts paid to appellant's own attorney and the entire $5,000 paid to Mrs. Newton's attorneys. Appeal is also made from these disallowances.

Section 17207 of the Revenue and Taxation Code provides for the deduction of debts which become worthless during the taxable year. Only a bona fide debt qualifies for purposes of that section. (Cal., Admin. Code, tit. 18, reg. 17207(a), subd. (3).) Whether advances to a corporation by a principal stockholder are loans or contributions to capital is essentially a question of fact. The taxpayer has the burden of proving that a bona fide debt existed and that he is therefore entitled to a deduction upon its becoming worthless. (Matthiessen v. Commissioner, 194 F.2d 659.)

In cases involving comparable federal legislation the courts have stressed a number of factors which are to be considered in determining the nature of an advance made by a stockholder. The basic inquiry appears to be: have the funds been put at the risk of the corporate venture, or is there a genuine expectation of repayment regardless of the success of the business? (Gilbert v. Commissioner, 248 F.2d 399.) The entire factual background must be examined in order to answer this question.

Though the form of the transaction is not conclusive, it is one of the circumstances to be considered in determining whether or not the parties intended to create a bona fide indebtedness. In the instant case, most of the usual formal indicia of indebtedness were absent. No debt instruments were created, no definite date for repayment was specified, no interest was paid and the advances were unsecured. In addition, appellant subordinated his claims to the claims of outside creditors. This is another indication of an equity investment

rather than a loan, (Gooding Amusement Co., 23 T.C. 408, aff'd, 236 F.2d 159, cert. denied, 352 U.S. 1031 [1 L. Ed. 2d 599].)

The debt-equity ratio of the corporation receiving the advances is another factor which is considered by the courts. An excessive ratio of corporate debt to *net* corporate capital may result in the conclusion that the corporation is inadequately capitalized and that advances by the shareholder in reality constitute additional capital investment rather than loans, (Gilbert v. Commissioner, 248 F.2d 399.) The debt-equity ratio in the instant case was more than 5 to 1 during the first year of operation, Within that year, expenses exceeded the amount denominated as equity capital and the corporation thereafter operated entirely on appellant's advances. These circumstances point toward a finding that the advances made by appellant were contributions to capital. (Dodd v. Commissioner, 298 F.2d 570; Diamond Bros. Co., T.C. Memo., Dkt. No. 87004, *May* 31, 1962, aff'd, 322 F.2d 725.)

The fact that appellant repeatedly advanced money to the corporation even though it was not proving to be a profitable operation is evidence of intent to invest capital. It is unlikely under those circumstances that an outside creditor would have-continued to make unsecured loans with expectation of repayment, (Dodd v. Commissioner, supra.)

The record indicates that appellant did recoup a portion of the advances. This fact would be of more consequence in a situation where the advancing stockholder was not in control of the corporation, (Diamond Bros. Co., supra.) As president of the corporation and owner of 81 percent of the stock, the rest of which was held by his own employees, appellant was in a position to balance his advances with withdrawals from time to time, at will. Because of appellant's dominant position also, we attach little significance to the fact that the advances were not made by all of the stockholders in proportion to the amounts of stock held by them. (Dodd v. Commissioner, supra,)

Appellant relies on the case of Byerlite Corp. v. Williams, 286 F.2d 285. In Byerlite the subsidiary corporation to which the parent corporation made advances was not expected to make a profit. Therefore the advancing shareholder could not possibly have had an intent to invest In order to enjoy the corporation's chances of profit. The subsidiary was created to conduct, for a limited time, one aspect of the parent's business and the purpose of the advances was to promote the business of the parent. More analogous to the case at hand is Dodd v. Commissioner, supra, where a sole proprietor advanced money to start and keep under way a new and under-capitalized

corporation In a business similar to but different from that of the proprietorship. On these facts, the court concluded that the advances were loans.

It appears that appellant's expectation of repayment was highly, conjectural, even after the business had gotten under way. Recoupment of the advances made was dependent upon the success of the business, Appellant has failed to prove that a debtor-creditor relationship existed between him and the corporation.

Appellantalso claims he is entitled to a deduction for legal fees incurred by him and his former wife and paid by him In connection with their divorce action. Section 17252, subdivision (b) of the Revenue and Taxation Code provides for the deduction of all ordinary and necessary expenses paid or incurred In connection with the management, conservation or maintenance of property held for the production of Income. Appellant contends that the attorneys' fees were incurred to protect his business from the claims of his former wife, that such business constituted community property, and that such fees are therefore deductible under section 17252.

The United States Supreme Court has recently settled this question In an Interpretation of comparable federal legislation. In 1963 the Court held that legal fees paid by the husband under similar circumstances were not deductible as expenses for the conservation of income-producing property, but were properly characterized as non-deductible personal or family expenses, (United States v. Gilmore 372 U.S. 39 [9 L. Ed. 2d 570]; United States v. Pat-72 U.S. 53 [9 L. Ed. 2d 5801.)

Respondent disallowed as deductions only 25 percent of the fees paid to appellant's attorney for his services in the divorce proceedings. In accordance with the above cited decisions, which were handed down after this appeal was filed, all of those deductions should have been disallowed, The statute of limitations prevents increasing the assessments for any of the years involved, (Rev, & Tax. Code, § 18586.) Since the assessment for the year 1955, however, will be reduced by allowing a deduction of $12,682.16 for payments to creditors of the corporation, there should be a corresponding offset by disallowing the entire deduction claimed for divorce fees for that year. The parties have not specified the amount of the divorce fees deducted for 1955, but the deduction should be disallowed to the extent that this can be done without increasing the amount of the assessment.

Appeal of George E. Newton

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of George E. Newton to proposed assessments of additfonal personal Income tax in the amounts of $2,188.21, $1,393.49 and $105.73 for the years 1955, 1956 and 1957, respectively, be modified by allowing for the year 1955 a deduction of $12,682.16, representing debts of the corporation which were paid by appellant, and by disallowing as a deduction the entire amount of divorce fees claimed for 1955. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 12th day of May, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman

Member

Member

Member

'Member

Attest: , Secretary